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[JOINT COMMITTEE PRINT]

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# DESCRIPTION OF S. 1784 (RETIREMENT INCOME POLICY ACT OF 1985)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

OF THE

SENATE COMMITTEE ON FINANCE

ON JANUARY 28, 1986

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PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JANUARY 27, 1986

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## INTRODUCTION

The Subcommittee on Savings, Pensions, and Investment Policy of the Senate Finance Committee has scheduled a public hearing on January 28, 1986, on S. 1784 (introduced by Senators Heinz and Chafee). The bill would set forth a national retirement income policy and would revise the rules of the Internal Revenue Code (Code) and the Employee Retirement Income Security Act of 1974 (ERISA) relating to coverage, vesting, integration, and portability under pension plans.

This pamphlet [1] is prepared by the staff of the Joint Committee on Taxation in connection with the Subcommittee's January 28 hearing. The first part of the pamphlet is a summary of the bill. The second part is a description of the provisions of the bill, including the relevant provisions of present law.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of S. 1784 (Retirement Income Policy Act of 1985)* (JCS-1-86), January 27, 1986.



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## I. SUMMARY OF THE BILL

### *Participation requirements*

#### *Retirement plans and nonretirement savings plans*

The bill would establish two types of deferred compensation plans, retirement plans and nonretirement savings plans, which could be maintained by employers. Under the bill, an employer could provide a nonretirement savings plan for an employee only if that employee is also a participant in a retirement plan that provides a specified minimum benefit. In addition, a retirement plan would be required to meet certain retirement income requirements, which provide restrictions on the timing and form of distributions from retirement plans.

Under the bill, a deferred compensation plan would be a nonretirement savings plan if it is not a retirement plan. The provisions with respect to retirement plans and nonretirement savings plans would be added to the Code and to ERISA.

#### *Coverage requirements*

The bill would revise the coverage requirements applicable to qualified plans under the Code and would extend those requirements to all pension plans subject to ERISA.

Under the bill, an employer would be considered to meet the coverage requirements if each employee in the employer's relevant workforce whose compensation is less than the social security contribution and benefit base (i.e., the wage base) is eligible to participate in a retirement plan maintained by the employer. Special rules would apply to permit coverage to be tested separately if the relevant workforce of the employer consists of two or more allowable subdivisions.

In addition, the bill would provide a special coverage test in the case of a retirement plan of an employer that provides for mandatory employee contributions if the retirement plan is used to qualify a nonretirement savings plan of the employer.

### *Limitations on deductions, contributions, and benefits*

The bill would restrict the deduction for qualified voluntary employee contributions to contributions made to a retirement plan.

The bill would revise the rules of the Code relating to qualified cash or deferred arrangements (401(k) plans) and would add corresponding rules to ERISA. Under the bill, a cash or deferred arrangement could be provided only by a retirement plan that meets specified requirements relating to the coverage of employees. The bill would coordinate the exclusion provided for elective deferrals under a 401(k) plan with the deduction allowed to an employee for contributions to an individual retirement arrangement by reducing the deduction limit for contributions to an individual retirement



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arrangement by the amount of elective deferrals under a 401(k) plan.

Under the bill, the overall limits on contributions and benefits under qualified plans would be revised and the combined plan limit would be repealed if no plan in which the employee participates is top heavy.

The bill would relate the overall limits on benefits and contributions under qualified plans to the benefit and contribution base under the Social Security Act (i.e., the wage base ($42,000 for 1986)). Under a retirement plan, the dollar limit would be (1) 200 percent of the wage base in the case of a defined benefit plan, and (2) 50 percent of the wage base in the case of a defined contribution plan. The bill would provide further reductions for contributions and benefits under nonretirement plans and 401(k) plans. In addition, the bill would limit the amount of compensation that may be taken into account under a plan for purposes of the nondiscrimination provisions relating to qualified plans and the overall limits on benefits and contributions under a qualified plan. A corresponding limit on compensation taken into account would be provided by the bill under ERISA.

***Vesting standards***

The bill would amend ERISA and the Code to require that, in the case of a retirement plan, a participant who has completed at least 5 years of service has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions. In the case of a nonretirement savings plan, a participant would have a nonforfeitable right to 100 percent of employer contributions without regard to the participant's years of service. A special rule would apply for multiemployer retirement plans.

***Pension integration***

The bill would revise the integration rules under the Code for qualified plans and would add to the labor law a prohibition against discrimination by a pension plan in favor of specified employees similar to the rules of present law for qualified plans. Under the bill, a pension plan would not be considered to violate the nondiscrimination rules of the labor law or the tax law merely because the plan is integrated.

***Distributions***

The bill would repeal the 10-year forward income averaging and capital gains treatment of lump-sum distributions under qualified plans. In addition, under the bill, the 10-percent additional income tax on withdrawals from an IRA by the owner prior to the attainment of age 59½, death, or disability would be increased to 20 percent.

***Coverage and portability***

***Early distributions of benefits***

Under the bill, an accrued benefit would not be treated as nonforfeitable unless, in the case of any lump-sum distribution made before a participant attains age 59½, dies, or becomes disabled, the

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distribution is made in a direct transfer to an IRA of the participant.

***Special rules for simplified employee pensions (SEPs)***

The bill would revise the qualification requirements relating to SEPs to permit employees to elect to have SEP contributions made on their behalf or to receive the contribution in cash. This salary reduction feature would only be available to employers who have 25 or fewer employees. In addition, the bill would repeal the provision permitting SEP contributions to be integrated with social security and would apply a limitation on annual SEP contributions that is tied to the contribution and benefit base under the Social Security Act.

***Effective dates***

The bill generally would be effective with respect to any plan for plan years ending after the later of 2 years after the date of enactment of the bill or the earlier of (1) the effective date of the first plan amendment adopted after the date of enactment or (2) December 31, 1990. The provisions relating to individual retirement arrangements would be effective for taxable years ending after December 31, 1990.

A special effective date would be provided for collectively bargained plans. In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before the date of enactment, the bill would be effective for plan years ending after the later of 2 years after the date of enactment or the earliest of (1) the date on which the last of the collective bargaining agreements relating to the plan terminated (determined without regard to any extension ratified after the date of enactment), (2) the effective date of the first plan amendment adopted after the date of enactment, or (3) December 31, 1990.

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## II. DESCRIPTION OF THE BILL

### A. Overview of Tax-Favored Pension and Deferred Compensation Arrangements

***In general***

Under the Federal income tax system, individuals generally are taxed on income as it is earned. This principle has been applied to tax income that is made available (constructively received) in addition to income actually received. Under the economic benefit doctrine, if there is a transfer of property in exchange for services, the individual performing the services is required to include the value of the property in gross income when the property is not subject to a substantial risk of forfeiture. In addition, the gross income of a taxpayer generally includes noncash items that are equivalent to cash. An employer's deduction for compensation paid to an employee is postponed if the employer's income inclusion is postponed.

Historically, exceptions to the economic benefit doctrine have been adopted by Congress to encourage certain retirement savings by taxpayers. In particular, taxpayers have been encouraged by the tax law to set a part of their compensation aside under current programs that generally are designed to replace compensation upon retirement. Present law provides incentives by permitting taxpayers to postpone income tax on current compensation for retirement, and on investment earnings on those savings, under special plans of deferred compensation. Under these plans, income tax is generally postponed until the time benefits are paid, even though the benefits (if funded and nonforfeitable) would otherwise be currently taxable. Also, employers are allowed deductions (within limits) when contributions are made to these plans.

Since 1921, the Internal Revenue Code has specifically provided that certain employee trusts are exempt from Federal income tax. The 1921 Code provided an exemption for a trust forming part of a qualified profit-sharing or stock bonus plan.[2] The 1926 Code provided a similar exemption for qualified pension trusts and established deduction limits designed to set appropriate limits on the extent to which tax-favored treatment would be available under qualified plans.[3]

The standards for plan qualification have been revised and expanded since 1921 to reflect Congressional interest in the expansion of pension, profit-sharing, and stock bonus plans and concern over tax abuses. The rules relating to qualified plans were substantially revised by the Employee Retirement Income Security Act of 1974 (ERISA), which added (1) minimum coverage, vesting, benefit

[2] Sec. 219(f) of the Revenue Act of 1921.
[3] Sec. 219(f), sec. 23(p) of the Revenue Act of 1926.



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accrual, and funding requirements, and (2) overall limits on contributions and benefits. That Act also provided for protection of pension benefits under the labor laws and for insurance of some benefits under defined benefit pension plans by the Pension Benefit Guaranty Corporation (PBGC).

In addition to the deferral of income tax on amounts contributed to a qualified plan, present law provides an exclusion from exployment taxes (FICA and FUTA) for the amounts deferred under and the benefits paid from a qualified plan. This employment tax exclusion does not apply to elective deferrals under a qualified cash or deferred arrangement. Present law also provides relief from the effect of graduated tax rates by providing special income averaging rules for certain lump sum distributions and special treatment for net unrealized appreciation on employer securities.

***Types of tax-favored retirement arrangements***

***Qualified plans***

Under a plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan), an employer is allowed a deduction for contributions (within limits) to a trust to provide employee benefits. Similar rules apply to plans funded with annuity contracts. A qualified ' n may be a pension, profit-sharing, or stock bonus plan.

A qualified pension plan may be either a defined benefit pension plan or a money purchase pension plan. Under a defined benefit pension plan, benefit levels are specified under a plan formula and are not solely dependent on the balance of an account for the employee. For example, a defined benefit pension plan might provide a monthly benefit of $10 for each year of service completed by an employee. Benefits under a defined benefit pension plan may also be specified as a flat or step-rate percentage of the employee's average compensation or career compensation. Benefits under a defined benefit pension plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation (a Federal corporation within the Department of Labor).

Under a money purchase pension plan, the amount of employer contributions allocated to the account of an employee must be fixed or determinable. A money purchase pension plan is a type of defined contribution plan; therefore, the amount an employee is entitled to receive is based solely on the balance in the employee's account. Benefits may be paid under a defined benefit pension plan or a money purchase pension plan only in the event of death, disability, separation from service, or attainment of normal retirement age.

Profit-sharing and stock bonus plans are also types of defined contribution plans. Under a profit-sharing plan, employer contributions are provided out of current or accumulated profits of the employer. Under a stock bonus plan, contributions may be made under a fixed formula or they may be related to profits of the employer. The rules for stock bonus plans generally require that benefits be distributed in the form of employer stock. Under a profit-sharing or stock bonus plan, benefits can be distributed to an employee who has not separated from service.

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An employer's deductions and an employee's benefits under a qualified plan may be limited by reference to the employee's compensation. The Code also imposes overall limits on benefits or contributions that may be provided under qualified plans. In addition, subject to limits similar to the rules for individual retirement accounts (IRAs), certain employee contributions may be deductible when made. Investment earnings on the assets of a qualified plan are generally exempt from income tax until distributed.

Under a qualified plan, employees do not include benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. Tax deferral is provided under qualified plans from the time contributions are made until the time benefits are received. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee's income inclusion is deferred.

Benefits or contributions under a qualified plan are subject to standards designed to prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated. In addition, qualified plans are required to meet minimum standards relating to coverage (what employees participate in the plan), vesting (the time at which an employee's benefit becomes nonforfeitable), and benefit accrual (the rate at which an employee earns a benefit). Also, minimum funding standards apply to the rate at which employer contributions are required to be made to ensure the solvency of pension plans.

Coverage under employer pension plans in the United States increased from approximately 15 percent of the nonagricultural workforce in 1940 to 41 percent in 1960. Since 1960, it has increased at a much slower rate so that, by 1983, 48.5 percent of the nonagricultural workforce (or 44.3 million workers) was covered by a plan. Table 1, below, shows the distribution of coverage under pension plans by compensation levels for 1983.

**Table 1.—Distribution of Total Nonagricultural Wage and Salary Workers With Employer Pension Plans, 1983**

| Wage and salary class | Total wage and salary workers (thousands) | Workers with employer-provided pension plan | |
|---|---|---|---|
| | | Number (thousands) | Percent of workers |
| Less than $5,000 | 17,766 | 1,568 | 8.8 |
| $5,000–$10,000 | 16,961 | 4,908 | 28.9 |
| $10,000–$20,000 | 29,926 | 17,405 | 58.2 |
| $20,000–$30,000 | 16,103 | 12,216 | 75.9 |
| $30,000–$50,000 | 8,544 | 6,672 | 78.1 |
| Over $50,000 | 2,088 | 1,529 | 73.2 |
| Total | 91,388 | 44,298 | 48.5 |

Source: Office of Tax Analysis, U.S. Treasury and 1984 Current Population Survey (reported data at 1983 levels).

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Little or no data are available concerning the extent to which individuals who are participating in employer-provided plans actually receive benefits from the plans. Some participants will terminate employment with their employers before vesting in any accrued benefits. Other participants will remain with an employer long enough to obtain vested rights, but their benefits will be partially or fully offset by social security benefits (through social security integration) considered to be provided by their employers.

***Tax-sheltered annuities***

Tax-sheltered annuity programs may be established by public educational institutions and certain tax-exempt organizations (including churches and other organizations described in Code sec. 501(c)(3)) to provide retirement benefits to employees. Approximately 3 million persons are presently covered by these annuities.

Amounts paid by such an employer to purchase a tax-sheltered annuity (which may consist of shares of a regulated investment company (a mutual fund or a closed-end investment company)) are excluded (within limits) from the gross income of an employee even though the employee has a nonforfeitable right to benefits. Tax is also deferred on the investment earnings under a tax-sheltered annuity program. Over $3 billion in contributions were made to tax-sheltered annuities in 1983.

Tax-sheltered annuities may provide for nonexcludable employee contributions. Also, subject to rules similar to those provided for IRAs, certain employee contributions may be deducted by an employee. The limits on exclusions under tax-sheltered annuity programs may be higher than those for qualified plans.

Unlike qualified plans, tax-sheltered annuity programs are not subject to standards that prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated.

***Individual retirement arrangements (IRAs)***

An individual is allowed a deduction for contributions (within limits) to provide retirement benefits under an individual retirement account or an individual retirement annuity (an IRA). Deductions are limited by reference to the individual's compensation. An individual is generally not taxed on amounts held by an IRA, including investment earnings, until benefits are distributed. Tax deferral is provided during the period between the contribution of compensation and the receipt of benefits. Amounts held by an IRA are subject to restrictions designed to restrain nonretirement use of the funds.

For tax year 1983, contributions to IRAs exceeded $32 billion. This total includes deductible contributions and tax-free rollovers.

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## B. Statement of National Retirement Income Policy Goals

### *Present Law*

Although policy goals have been stated in the legislative history of the provisions of present law with respect to retirement income programs, that policy has not been provided by statutory provisions.

### *Explanation of Provision*

***In general***

The bill states findings of the Congress with respect to retirement income policy and would declare national retirement income policy goals.

***Findings***

According to the bill, the Congress finds that:

(1) The growth in the size, scope, and number of employee pension benefit plans has been substantial over the past quarter of a century;

(2) Since the enactment of the Employee Retirement Income Security Act of 1974, the number of workers and their families receiving benefits under these plans has steadily increased;

(3) For most workers and their families, the benefits paid by employee pension benefit plans are a necessary supplement to benefits received through the old-age, survivors, and disability insurance program under title II of the Social Security Act;

(4) Although the number of participants covered under these plans has increased, nearly half of current workers are not covered under any plan, and that percentage has remained relatively constant for the past decade;

(5) Even among workers covered by employee pension benefit plans, only 50 percent of those covered are currently entitled to receive benefits from those plans;

(6) The current rules regarding coverage, vesting, and integration of employee pension benefit plans with benefits under the old-age, survivors, and disability insurance program under title II of the Social Security Act tend to impede the policy goals of broadening of coverage and improving benefit delivery, particularly for mobile workers;

(7) Current incentives for plan formation have been inadequate and special incentives are needed to encourage small businesses to establish employee pension benefit plans;

(8) The lack of consistency and coordination of the rules governing various types of employee pension benefit plans has led to an erosion of the fundamental concept that retirement plans should provide retirement benefits;



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(9) The frequency with which legislative changes affecting employee pension benefit plans have been enacted over the past decade have led to both uncertainty as to what the law requires and substantial additional administrative expenses for such plans which, in turn, has discouraged the growth and development of employee pension benefit plans; and

(10) The lack of an articulated national retirement income policy has encouraged frequent and piecemeal changes.

***Declaration of policy***

The bill declares that its policy is to articulate certain basic national retirement income policy goals and to make certain changes to ERISA and the Code in pursuance of those goals.

The bill provides that it is the sense of the Congress that the following national retirement income policy goals should be pursued:

(1) The old-age, survivors, and disability insurance program under title II of the Social Security Act should be the universal and fundamental source of retirement income security for each American.

(2) Retirement benefits provided by title II of the Social Security Act should be supplemented with benefits provided from employer-financed retirement plans.

(3) Retirement benefits provided by title II of the Social Security Act and employer-financed pensions should be supplemented by individual savings for retirement.

(4) The current voluntary system of employer-sponsored retirement plans should be retained; and the growth and development of such plans should be encouraged.

(5) Although the age of retirement should be an individual decision, workers should be encouraged by public policy to remain in the work force throughout their productive years.

(6) Employer-sponsored retirement plans should be sufficiently flexible to deliver adequate retirement benefits to workers with a variety of career patterns.

(7) Benefits which are accumulated for retirement should be retained for that purpose.

(8) Although elective approaches to retirement savings may be useful in supplementing employer-financed retirement benefits, public policy should be developed with the recognition that employer-financed retirement programs can be more effective in delivering benefits to a broad cross-section of the population.

(9) Employer-sponsored savings for purposes other than retirement should be encouraged for employees participating in a meaningful retirement program.

(10) To the extent possible, retirement income should be provided from a variety of sources and should be sufficient to maintain an employee's preretirement standard of living throughout retirement.

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## C. Participation Requirements

### 1. Retirement plans and nonretirement savings plans (sec. 101, 102, 104, 201, 202, and 204 of the bill, secs. 3, 211, and 213 of ERISA, and secs. 401, 409A, and 414 of the Code)[4]

#### *Present Law*

***Distribution restrictions***

Under a qualified pension plan, benefits may be withdrawn on account of plan termination or an employee's separation from service, disability, death, or attainment of normal retirement age. Withdrawals from qualified profit-sharing or stock bonus plans are subject to fewer restrictions than withdrawals under qualified pension plans. Qualified profit-sharing or stock bonus plans generally may permit the withdrawal of employer contributions after the expiration of a stated period of time (2 years or longer) or after the occurrence of a stated event (e.g., hardship). Hardship distributions may also be permitted under a tax-sheltered annuity investing in a mutual fund. Plans to which the less restrictive withdrawal rules apply have been sometimes referred to as capital accumulation or savings plans.

Special restrictions apply to benefits under a qualified cash or deferred arrangement (a plan that is part of a profit-sharing, stock bonus, or pre-ERISA money purchase pension plan and that meets the requirements of sec. 401(k)). Generally, except for hardship, these benefits may not be withdrawn before an employee attains age 59½, separates from service, dies, or becomes disabled.

The Code does not provide restrictions on benefit distributions under most private nonqualified plans of deferred compensation. However, benefits under unfunded deferred compensation plans of State or local governments and of certain tax-exempt organizations are not permitted to be made available earlier than when the employee separates from service or is faced with an unforeseeable emergency.

The labor law provisions of ERISA contain no restrictions on benefit distributions.

***Prerequisite for nonretirement plan***

Present law does not specify a distinction (other than withdrawal restrictions) between retirement plans and nonretirement savings plans and does not prevent an employer from establishing one type of plan for employees because the employer does not also provide another type of plan.

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[4] References to ERISA mean the Employee Retirement Income Security Act of 1974, and references to the Code mean the Internal Revenue Code of 1954.



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## *Explanation of Provisions*

### *Overview*

The bill would establish two types of deferred compensation plans, retirement plans and nonretirement savings plans, which could be maintained by employers. Under the bill, an employer could provide a nonretirement savings plan for an employee only if that employee was also a participant in a retirement plan that provides a specified minimum benefit. In addition, a retirement plan would be required to meet certain retirement income requirements, which provide restrictions on in-service distributions from retirement plans and would provide restrictions on the form in which benefits could be paid under those plans.

Under the bill, a deferred compensation plan would be a nonretirement savings plan if it is not a retirement plan. The provisions with respect to retirement plans and nonretirement savings plans would be added to the Code and to the labor law.

In addition, under the bill, a retirement plan could not be converted by a plan amendment into a nonretirement savings plan.

### *Retirement income plans*

*Restrictions on time of distribution.*—Generally, a plan would meet the restrictions of the bill relating to the time of benefit distributions (the retirement income requirements) only if the plan provides for distribution of the accrued benefits with respect to each participant commencing not earlier than specified times. Under the bill, accrued benefits generally could not be distributed under a retirement plan until (i) the participant's disability, (ii) the participant's death, or (iii) the later of the participant's attainment of age 59½, or separation from service. The retirement income requirements could also be met by a plan if the plan provides for certain direct transfers.

Under the bill, in the case of a participant who has separated from service and who has not attained age 59½, died or become disabled, a distribution may be made upon separation from service if the distribution meets certain requirements. The bill provides that the distribution could be made upon separation from service if it is in a retirement income form and if the benefits will be paid no later than the time permitted by the bill.

The bill would require that the payment of benefits commence not later than the later of (1) the end of the plan year in which the employee attains age 70½, or (2) in the case of an employee other than an owner-employee (sec. 401(c)(3) of the Code), the end of the plan year in which the employee retires.

*Restrictions on benefit forms.*—The bill specifies three forms of benefit distribution (retirement income forms) that would satisfy the restrictions on the form in which benefits may be distributed upon separation from service to a participant who has not attained age 59½, died, or become disabled. Under the bill, the distribution may be made (1) in the form of an annuity for the life of the participant, (2) in the form of a qualified joint and survivor annuity (as defined in sec. 205(d) of ERISA or sec. 417(b) of the Code), or (3) in the form of a level distribution over life expectancy (which may be adjusted not more frequently than annually to account for changes



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in life expectancy and reasonable assumptions based on previous investment performance under the plan).

Under the bill, a distribution would not fail to be in a retirement income form merely because the distribution is adjusted to allow for periodic supplements that terminate upon commencement of entitlement to benefits under the Social Security Act (e.g., a social security supplement), and after adding benefits otherwise paid under the plan for periods for which such supplements are paid, do not exceed the amount of those projected benefits under the Social Security Act and the plan upon the commencement of entitlement.

The bill would also permit the distribution of certain sickness, accident, or disability benefits (sec. 3(1) of ERISA).

*Direct transfers.*—The bill provides that a plan would not be treated as failing to meet the retirement income requirements solely because the plan provides for a direct transfer, to an IRA or to another retirement plan that accepts such direct transfers, of the accrued benefit with respect to the participant upon the participant's separation from service under the plan. See, also, part H.1., which describes provisions of the bill permitting certain direct transfers to an IRA without the participant's consent.

***Nonretirement savings plans***

Under the bill, a defined contribution plan that does not meet the requirements for status as a retirement plan would be a nonretirement savings plan. The bill would prohibit an employer from maintaining a nonretirement savings plan for an employee unless the employee participates in at least one retirement plan (a prerequisite plan) that meets specified requirements.

If the prerequisite plan is a defined benefit pension plan, then the bill would require that the defined benefit pension plan provide the participant with an accrued benefit equivalent to a specified amount. The bill provides that the specified amount would be determined by multiplying one-half of one percent by the product of (1) the amount of the participant's compensation (sec. 415 of the Code), and (2) the number of the participant's years of plan participation (sec. 411 of the Code).

The bill provides that if the prerequisite plan is a defined contribution plan, then the employer contribution with respect to each participant for each plan year must not be less than 3 percent of the participant's compensation (sec. 415 of the Code) for the plan year.

**2. Coverage requirements (secs. 103 and 203 of the bill, secs. 202 and 212 of ERISA, and secs. 401, 409B, and 410 of the Code)**

***Present Law***

The coverage requirements applicable to qualified plans (Code sec. 410(b)) require that a plan cover employees in general rather than merely the employer's top-ranking employees. A plan generally satisfies the present-law coverage rule if (1) it benefits a significant percentage of the employer's workforce (percentage test), or (2) it benefits a classification of employees determined by the Secretary of the Treasury not to discriminate in favor of employees who

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are officers, shareholders, or highly compensated (fair cross-section test). Present law does not require that an employer cover all employees (other than excludable employees).

Under present law, the coverage requirements do not apply under ERISA.

***Percentage test***

A plan meets the percentage test if (1) it benefits at least 70 percent of all employees, or (2) it benefits at least 80 percent of the employees eligible to benefit under the plan and at least 70 percent of all employees are eligible (i.e., the plan benefits at least 56 percent of all employees).

***Fair cross-section test***

A plan meets the fair cross-section test if the Secretary of the Treasury determines that it covers a classification of employees that is found not to discriminate in favor of employees who are officers, shareholders, or highly compensated. In making that determination, the Secretary is required to consider all the surrounding facts and circumstances, allowing for a reasonable difference between the ratio of highly compensated employees who are benefited by the plan to all such employees and the corresponding ratio calculated for employees who are not highly compensated.

***Aggregation rules***

*Controlled groups.*—In applying the qualification rules (including both the percentage and fair cross-section coverage tests), all employees of corporations that are members of a controlled group of corporations, or all employees of trades and businesses (whether or not incorporated) that are under common control, are aggregated and treated as if employed by a single employer (Code sec. 414(b) and (c)).

*Affiliated service groups.*—All employees of employers that are members of an affiliated service group of employers are treated as employed by a single employer for purposes of the qualification requirements (Code sec. 414(m)). An affiliated service group consists of a service organization (the "first organization") and (1) each other service organization that is related to the first organization and (2) each other service organization that is related to either the first organization, or to a service organization that is related to the first organization. In determining whether a group of employers constitutes an affiliated service group, certain attribution rules apply.

*Employee leasing arrangements.*—For purposes of certain of the tax-law rules for qualified plans and SEPs, an individual (a leased employee) who performs services for another person (the recipient) is treated as the recipient's employee if the services are performed pursuant to an agreement between the recipient and a third person (the leasing organization) who has contracted with the recipient for the individual's service (Code sec. 414(n)). The individual is treated as the recipient's employee only if the individual has performed services for the recipient (or for the recipient and persons related to the recipient) on a substantially full-time basis for a period of at

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least 12 months, and if the services are of a type historically performed by employees in the recipient's business field.

However, under a safe-harbor provision, an individual who otherwise would be treated as a recipient's employee pursuant to these rules is not treated as such an employee if certain requirements are met with respect to contributions provided for the individual under a qualified money purchase pension plan maintained by the leasing organization. The safe-harbor rule is inapplicable to a leased employee who is otherwise a common-law employee of the recipient.

*Other aggregation.*—The Secretary of the Treasury also has the regulatory authority to develop any rules as may be necessary to prevent the avoidance of any employee benefit requirement to which the employee leasing or affiliated service group provisions apply through the use of employee leasing or other arrangements (Code sec. 414(o)).

***Excludable employees***

In applying the percentage test, certain employees who have not yet completed minimum periods of service (generally one year [5]) and employees who have not yet attained age 21 may be disregarded if they are excluded pursuant to a plan provision. In addition, in applying both the percentage and the fair cross-section test, employees included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives [6] and one or more employees are disregarded if they are excluded pursuant to a plan provision and there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and the employer or employers (Code sec. 410(b)(3)(A)). Certain nonresident aliens and certain airline employees must be excluded from consideration (Code sec. 410(b)(3) (B) and (C)).

***Tax-sheltered annuities***

Under present law, no coverage or nondiscrimination rules apply to prohibit an employer's tax-sheltered annuity program from favoring highly compensated employees.

***Explanation of Provisions***

***In general***

The bill would revise the coverage requirements applicable to qualified plans under the Code and would extend those requirements to apply to all pension plans subject to ERISA.

Under the bill, an employer would be considered to meet the coverage requirements if each employee in the employer's relevant workforce whose compensation is less than the social security contribution and benefit base (i.e., the wage base) is eligible to participate in a retirement plan maintained by the employer.

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[5] Under a special rule, an employee may be excluded from participation for up to three years provided the employee is, after three years, fully and immediately vested.

[6] An organization is not considered to be an employee representative if more than one-half of its members participating in the plan are employees who are also owners, officers, or executives of the employer.

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The bill provides that the coverage requirements would not limit the application of the general nondiscrimination rules applicable to qualified plans (sec. 401(a)(4) of the Code).

***Special rules for subdivisions***

Under the bill, if the relevant workforce of the employer consists of two or more allowable subdivisions, the coverage requirements would be considered to be met if two tests are met.

Under the first test, all employees in each allowable subdivision who earn less than the social security wage base would be required to be eligible to participate in a retirement plan maintained by the employer. This first test would not apply to an allowable subdivision if no employee in the allowable subdivision is eligible to participate in a retirement plan maintained by the employer.

The second test would apply to all employees of the employer (not merely to employees within an allowable subdivision). This test would be met if the percentage of the relevant workforce (the coverage percentage) of employees who (1) earn less than the social security wage base ($42,000 for 1986), and (2) are eligible to participate in a retirement plan maintained by the employer is at least 80 percent as of the end of the last fiscal year of the employer. Alternatively, the second test would be satisfied if the average of the coverage percentages as of the end of each of the last 5 fiscal years of the employer (or all preceding fiscal years of the employer, if less than 5) is at least 80 percent.

***Multiple plans of an employer***

Under the bill, the coverage requirements (to the extent that they require an employer to maintain a retirement plan) would be met if the employer maintained more than one plan and if each employee is eligible to participate in at least one retirement plan of the employer.

***Rules for contributory plans***

In the case of a plan that provides for mandatory employee contributions, the coverage requirements would be met only if, in addition to meeting the general coverage requirements, at least 60 percent of the employees who are eligible to participate actually benefit under the plan. Under the bill, the 60 percent test would be increased to 70 percent in the case of a retirement plan that is maintained as a prerequisite for a nonretirement savings plan.

Under the bill, the term "mandatory contributions" would mean amounts contributed to the plan by a participant that are required as a condition of employment, as a condition of participation in the plan, or as a condition of obtaining benefits under the plan attributable to employer contributions.

***Modification of minimum participation standards***

The bill would repeal the present-law rule under which an employee may be required to complete three years of service before becoming eligible to participate in a plan maintained by an employer as long as the plan provides for full and immediate vesting upon plan participation.

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***Definitions***

*Relevant workforce.*—Under the bill (as under present law), the term relevant workforce would mean all employees of an employer other than certain excludable employees. An excludable employee would include the following employees:

(1) Employees who have not met the minimum age or service requirements, if any, for participation in any pension, profit-sharing, or stock bonus plan established or maintained by the employer;

(2) Employees who do not participate in any pension, profit-sharing, or stock bonus plan established or maintained by an employer and who are included in a unit of employees covered by an agreement that the Secretary finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers;

(3) Employees who are included in a unit of employees covered by an agreement pursuant to which a pension, profit-sharing, or stock bonus plan is maintained by the employer and that the Secretary finds to be a collective-bargaining agreement between airline pilots and one or more employers (unless the principal duties of such employee are not customarily performed aboard aircraft in flight); or

(4) Employees who are nonresident aliens and who receive no earned income from the employer that constitutes U.S. earned income.

*Allowable subdivision.*—The bill would define the term allowable subdivision to mean the portion of the relevant workforce of the employer that serves in a separate business unit as defined in Treasury regulations distinguishing such business unit solely on the basis of its distinct locality or its separate product line. Further, the bill would define an allowable subdivision to include the portion of the relevant workforce of the employer that does not serve in the workforce of any such separate business unit.

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**D. Limitations on Deductions, Contributions, and Benefits (secs. 111, 112, 211, 212, 213, 214, and 215 of the bill, secs. 214 and 306 of ERISA, and secs. 72, 219, 401, 402, and 415 of the Code**

***Present Law***

***Individual retirement accounts and annuities***

The individual retirement savings provisions of the Code were originally enacted in ERISA to provide a tax-favored retirement savings arrangement to individuals who were not covered under a qualified plan or a governmental plan maintained by the employer. Those who were active participants in employer plans were not permitted to make deductible IRA contributions.

In the Economic Recovery Tax Act of 1981 (ERTA), Congress eliminated the provision restricting IRA eligibility to individuals who were not active participants and increased both the dollar and percentage of compensation limitations, from the lesser of 25 percent of compensation or $1,500, to the lesser of 100 percent of compensation or $2,000. In addition, ERTA provided rules permitting deductible employee contributions (or qualified voluntary employee contributions) to be made to a qualified plan.

Under present law (Code sec. 219), an individual generally is entitled to deduct from gross income the amount contributed to an IRA (within limits). The limit on the deduction for a taxable year generally is the lesser of $2,000 or 100 percent of compensation (earned income, in the case of income from self-employment). Similar rules apply with respect to qualified voluntary employee contributions made by an employee under a qualified plan. To the extent that a deduction is allowed to an individual for a year with respect to a qualified voluntary employee contribution, the limit for the year on deductions for a contribution to an IRA is reduced.

***Cash or deferred arrangements (401(k) plans)***

***In general***

Before the enactment of ERISA, some employers permitted employees to decide whether to accept compensation in cash or defer the compensation by having the employer contribute it to a profit-sharing plan. The Internal Revenue Service raised questions as to whether, under the usual tax principles of constructive receipt, employees who could have received cash, but chose to defer compensation, should be taxed as though they had received the cash. ERISA provided a limited moratorium on the issuance of Treasury regulations and IRS rulings relating to the application of the constructive receipt rule to employee deferrals under qualified plans. The moratorium was extended through 1978, when Congress enacted special rules relating to qualified cash or deferred arrangements (also referred to as CODAs or sec. 401(k) plans). Under these rules, if the



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requirements of the Code are met, an employee can choose deferral of compensation (within limits) without being taxed as though the compensation had been received.

If a tax-qualified profit-sharing or stock bonus plan (or certain pre-ERISA money purchase pension plans) meets certain requirements described below (a "qualified cash or deferred arrangement"), then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash.

***Nondiscrimination requirements***

The amount a highly paid employee can elect to defer, tax free, under a qualified cash or deferred arrangement depends (in part) on the level of elective deferrals by other employees. Special nondiscrimination tests apply a limit on elective deferrals by the group of highly paid employees that is determined by reference to deferrals by other employees. An employee is considered highly paid, for this purpose, if the employee is more highly compensated than ⅔ of all of the eligible employees. These nondiscrimination tests provide that the special treatment of elective deferrals is not available unless the cash or deferred arrangement does not disproportionately benefit highly paid employees.

The tests are based on the relationship of the actual deferral percentage for the group of highly paid employees to the actual deferral percentage for the group of other eligible employees. The deferral percentage for an employee for a year is the percentage of that employee's compensation that has been electively deferred for the year. The actual deferral percentage for a group of employees is the sum of the deferral percentages for the employees divided by the number of employees in the group eligible to defer.

A cash or deferred arrangement meets these special nondiscrimination requirements for a plan year if (1) the actual deferral percentage for the highly paid employees does not exceed the actual deferral percentage of the other eligible employees by more than 150 percent, or (2) the actual deferral percentage for the highly paid employees does not exceed the actual deferral percentage of the other eligible employees by more than three percentage points. If the three percent test is used, the actual deferral percentage for the highly paid employees also cannot exceed the actual deferral percentage of all other eligible employees by more than 250 percent. In calculating these deferral percentages, contributions by the employer that (1) are nonforfeitable when made and (2) satisfy the withdrawal restrictions applicable to elective deferrals may be taken into account as elective deferrals by employees.

The special nondiscrimination tests applicable to cash or deferred arrangements apply in lieu of the usual nondiscrimination rules for qualified plans, which permit employer contributions to social security to be taken into account. These special nondiscrimination rules do not replace, however, the usual rules requiring that a qualified plan cover either a specified percentage of employees or a fair cross-section of employees.

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*Withdrawal restrictions*

Under present law, a participant in a qualified cash or deferred arrangement is not permitted to withdraw elective deferrals (and earnings thereon) prior to age 59½, death, disability, separation from service, retirement, or the occurrence of a hardship. What constitutes the occurrence of a hardship under present law has not been defined except in proposed regulations.

*Limit on elective deferrals*

Elective deferrals under a qualified cash or deferred arrangement are subject to the overall limits on contributions to a defined contribution plan. Thus, under present law, the elective deferrals made by a participant, together with all other annual additions made to any plan of the employer on behalf of the participant, generally cannot exceed the lesser of $30,000 or 25 percent of the participant's nondeferred compensation.

*Limits on contributions and benefits under qualified plans*

*In general*

ERISA added overall limits on contributions and benefits under qualified plans and tax-sheltered annuities (Code sec. 415). The overall limits apply to contributions and benefits provided to an individual under all qualified plans, tax-sheltered annuities, and simplified employee plans (SEPs) maintained by any private or public employer or by certain related employers. The limits provided by ERISA were automatically adjusted for inflation. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced the limits and suspended cost-of-living increases. The Deficit Reduction Act of 1984 further suspended cost-of-living increases through 1987.

*Defined contribution plans*

Under a defined contribution plan, an overall limit applies to the annual addition with respect to each plan participant (Code sec. 415(c)). As originally enacted, the annual addition (consisting of employer contributions, certain employee contributions, and forfeitures allocated from the accounts of other participants) generally was limited to the lesser of (1) 25 percent of compensation for the year, or (2) $25,000, adjusted for cost-of-living increases, as measured by the changes in the consumer price index (CPI) since 1974. By 1982, the dollar limit, as increased to reflect cost-of-living adjustments, was $45,475. In 1982, TEFRA reduced the dollar limit from $45,475 to $30,000.

*Defined benefit pension plans*

Under a defined benefit pension plan, the limit on the annual benefit derived from employer contributions adopted in ERISA was the lesser of (1) 100 percent of average compensation, or (2) $75,000, adjusted for cost-of-living increases, as measured by the CPI since 1974. By 1982, the dollar limit on annual benefits, as increased to reflect cost-of-living adjustments, was $136,425. In 1982, TEFRA reduced that dollar limit from $136,425 to $90,000.

Prior to TEFRA, the annual benefit generally was the equivalent of an annuity for the life of the participant, beginning at age 55 or

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later, and determined without regard to certain survivor and nonretirement benefits. If retirement benefits commenced before age 55, the dollar limit was actuarially reduced. TEFRA provided that the new $90,000 limit (but not the 100 percent of compensation limit) is reduced if benefits commence before age 62 (rather than age 55). Thus, for benefits commencing before age 62, the $90,000 limit generally is reduced so that it is the actuarial equivalent of an annual benefit of $90,000 commencing at age 62. In no event, however, is the dollar limit applicable to benefits commencing at or after age 55 less than $75,000. If retirement benefits commence before age 55, the dollar limit is actuarially reduced so that it is the actuarial equivalent of a $75,000 annual benefit commencing at age 55.

The Code provides that reduced limits apply to participants with fewer than ten years of service. The limits are reduced by ten percent per year for each year of service less than ten. For example, benefits commencing at or after age 62 with respect to a participant who had only three years of service could not exceed 3/10 of $90,000 ($27,000).

***Employee contributions***

Under the Code, only a portion of nondeductible employee contributions to a qualified plan is taken into account in applying the overall limits. The amount taken into account is the lesser of one-half of the employee contributions or total employee contributions in excess of six percent of compensation. Therefore, if total employee contributions do not exceed six percent of compensation, no employee contributions are counted as annual additions.

***Combined plan limit***

The Code also provides an aggregate limit applicable to employees who participate in more than one type of plan maintained by the same employer.

If an employee participates in a defined contribution plan and a defined benefit pension plan maintained by the same employer, the fraction of the separate limit used for the employee by each plan is computed and the sum of the fractions is subject to an overall limit (Code sec. 415(e)). As originally enacted, the sum of the fractions was limited to 1.4. In 1982, TEFRA redefined the fractions and limited the sum of the two fractions to 1.0. Although the sum of the fractions is 1.0, adjustments made to the denominators of the revised fractions effectively provide an aggregate limit of the lesser of 1.25 (as applied to the dollar limits) or 1.4 (as applied to the percentage of compensation limits).

***Aggregate limit on contributions and benefits for key employees in a top-heavy plan***

Under present law, the combined plan limit may be reduced for an employee who participates in both a defined benefit pension plan and a defined contribution plan one of which is top heavy. Unless certain requirements are met, for any year for which one of the plans is top heavy, the new fractions are modified, effectvely providing the employee with an aggregate limit equal to the lesser

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of 1.0 (as applied to the dollar limits) or 1.4 (as applied to the percentage of compensation limits).

These modifications do not apply if the plans of the employer in which the employee participates (1) are not super top heavy (i.e., do not provide more than 90 percent of the benefits for key employees), and (2) provide either an extra minimum benefit (in the case of the defined benefit pension plan) or an extra minimum contribution (in the case of the defined contribution plan) for non-key employees participating in the plans.

***Tax-sheltered annuities***

The amount paid by an employer under a tax-sheltered annuity is excluded from the employee's income for the taxable year to the extent that the payment does not exceed the employee's exclusion allowance for the taxable year. The exclusion allowance is generally equal to 20 percent of the employee's includible compensation from the employer multiplied by the number of the employee's years of service with that employer, reduced by amounts already paid by the employer to purchase the annuity.

Employer payments to purchase a tax-sheltered annuity contract for an employee are also subject to the overall limits on contributions and benefits under qualified plans (Code sec. 415). Tax-sheltered annuities are generally defined contribution arrangements.[7] Under the overall limits, annual additions to tax-sheltered annuities and other defined contribution arrangements for the employee may not exceed the lesser of $30,000 or 25 percent of the employee's compensation from the employer for the year. Under a special rule (Code sec. 415(c)(4)(C)), an employee of an educational institution, hospital, home health service agency, or church may elect to compute the annual exclusion allowance for payments under a tax-sheltered annuity solely by reference to the maximum annual employer payment that could be made under the overall limit.

In addition, to allow certain lower-paid employees catch-up payments (i.e., payments permitted under the exclusion allowance on account of prior years of service, but denied under the overall annual limit that takes into account only the current year), alternative special elections are provided to increase the overall limit for the year of the election. An individual is allowed only one of the special election under section 415.[8]

In addition, a church employee may make an additional election pursuant to which the church may make payments for the year in excess of the otherwise applicable overall annual limit.[9] The elec-

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[7] The Economic Recovery Tax Act of 1981 (ERTA) provided that a church-maintained retirement income program in existence on September 3, 1982, will not be considered as failing to satisfy the requirements for a tax-sheltered annuity (Code sec. 403(b)) merely because the program is a defined benefit pension plan (Code sec. 414(j)).

[8] The first alternative catch-up election (Code sec. 415(c)(4)(A)) may be made only for the year of an employee's separation from the service of the contributing employer (the separation year catch-up election). The second alternative catch-up election (Code sec. 415(c)(4)(B)) generally may be made for any year, but is subject to additional limitations. Neither election increases the amount excludable from the employee's income for the year under the exclusion allowance.

[9] The employee's election increases the overall annual limits (subject to the employee's exclusion allowance) to the lesser of (1) the amount paid by the church for the year, or (2) $10,000. Employer payments permitted for a church employee under this provision (i.e., payments in excess of the otherwise applicable annual limits) may not exceed $40,000 for the employee's lifetime.

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tion may not be made for the same year in which a catch-up election is effective.

### *Explanation of Provisions*

#### *In general*

The bill would restrict the deduction for qualified voluntary employee contributions made by plan participants. Under the bill, the deduction would be allowed only for a contribution to a retirement plan.

The bill would revise the rules of the Code providing for qualified cash or deferred arrangements (401(k) plans) and would provide corresponding labor law rules. Under the bill, a cash or deferred arrangement could be provided only by a retirement plan that meets specified requirements relating to the coverage of employees. The bill would coordinate the exclusion provided for elective deferrals under a 401(k) plan with the deduction allowed to an employee for contributions to an IRA. Under the bill, the deduction limit for contributions to an IRA would be reduced by the amount of elective deferrals under a 401(k) plan.

Under the bill, the overall limits on contributions and benefits under qualified plans would be revised. The bill would provide further reductions for contributions and benefits under nonretirement plans. In addition, the bill would limit the amount of compensation that may be taken into account under a qualified plan for purposes of determining whether benefits and contributions under a plan meet the requirements of the Code. A corresponding limit on compensation taken into account would be provided by the bill under labor law.

Finally, the bill would repeal the combined limit that applies if an employee participates in more than one plan of the employer unless one of the plans in which the employee participates is top heavy.

#### *Qualified voluntary employee contributions*

Under the bill, a voluntary employee contribution to a plan would not be deductible unless it is made to a retirement plan. For rules defining retirement plans under the bill, see part C., above.

#### *Cash or deferred arrangements (401(k) plans)*

##### *In general*

The bill would restrict cash or deferred arrangements to retirement plans. Accordingly, under the bill, a pension, profit-sharing, or stock bonus plan could not provide a cash or deferred arrangement unless the plan meets the requirements for status as a retirement plan (see part C., above).

The bill defines a cash or deferred arrangement as any arrangement that is part of a plan and under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash. Accordingly, under the bill, a cash or deferred arrangement could be maintained under a pension plan (including a defined benefit pension plan) that is a retirement pian. The bill

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would continue present law under which an employee's right to the accrued benefit derived from employer contributions with respect to employee deferrals under a cash or deferred arrangement is required to be nonforfeitable.

The changes made under the bill with respect to cash or deferred arrangements would also apply for labor law purposes.

***Relationship of deferral percentages***

The bill would continue present law under which a cash or deferred arrangement would not be treated as meeting the requirements of the Code unless the actual deferral percentage for highly compensated employees for a plan year bears a specified relationship to the actual deferral percentage for all other eligible employees for that year. Under the bill, as under present law, an arrangement may meet a 1.5 multiplier test or a 2.5 multiplier test. The bill would continue the rules of present law with respect to employers who maintain 2 or more plans that include cash or deferred arrangements and for employees who participate in more than one cash or deferred arrangement of an employer.

The bill would provide for application of the nondiscrimination tests for cash or deferred arrangements on the basis of allowable subdivisions of an employer's employees (see part C., above, for a definition of allowable subdivisions). Under the bill, in the case of any plan that would not meet the retirement income requirements without the application of the provisions of the bill relating to allowable subdivisions, the tests for cash or deferred arrangements would be applied on the basis of each separate allowable subdivision.

***Coordination with individual retirement accounts and annuities***

The bill would provide rules coordinating the level of deductible contributions to individual retirement accounts and individual retirement annuities (IRAs) with elective deferrals under qualified cash or deferred arangements. The bill would continue the rules of present law under which the limit on deductible contributions to IRAs are coordinated with qualified voluntary employee contributions.

Under the bill, if an individual makes elective deferrals under a cash or deferred arrangement that is a retirement plan, then the amount of the IRA contributions which are paid for the taxable year and which are allowable as a deduction is to be reduced by the amount of the individual's elective deferrals under the cash or deferred arrangement.

***Wage-based limits on contributions and benefits***

***In general***

The bill would limit the amount of compensation taken into account for purposes of applying the nondiscrimination and integration rules applicable under the Code and under ERISA and for purposes of computing the overall limits on contributions and benefits. The bill would also modify the separate limits with respect to defined benefit pension plans and defined contribution plans. Re-

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duced limits would apply to a nonretirement savings plan. The combined limit applicable to an employee who participates both in a defined benefit pension plan and a defined contribution plan of the same employer would be applied only if at least one of the plans in which the employee participates is top heavy. These limits would also apply to tax-sheltered annuities.

Under the bill, the dollar limit for a defined benefit pension plan would be 200 percent of the contribution and benefit base under the Social Security Act. For a defined contribution plan that is a retirement plan, the bill would provide a dollar limit of 50 percent of the contribution and benefit base under the Social Security Act.

For a nonretirement savings plan, the bill would provide a limit of the lesser of 25 percent of the contribution and benefit base under the Social Security Act or 10 percent of the participant's compensation.

The limit on elective deferrals under a cash or deferred arrangement would be reduced to 25 percent of the contribution or benefit base under the Social Security Act.

***Compensation taken into account***

The bill would provide a limit on the level of compensation taken into account in applying the overall limits and for purposes of the nondiscrimination and integration rules under the Code and the labor law. Under the bill, the compensation taken into account would be limited to 500 percent of the contribution and benefit base under the Social Security Act (the compensation limit would be $210,000 if it applied in 1986).

***Defined benefit pension plans***

The bill would provide that the limit applicable to the annual benefit under a defined benefit pension plan is the lesser of 200 percent of the contribution and benefit base under the Social Security Act (the limit on the annual benefit would be $84,000 if the bill applied in 1986) or 100 percent of the participant's high 3-year average compensation. Because the limit on annual benefits would be linked directly to the contribution and benefit base under the Social Security Act, the limit for a year would be automatically adjusted for inflation when the contribution and benefit base under the Social Security Act is adjusted.

***Defined contribution plans***

For a defined contribution plan that is a retirement plan, the bill would generally limit the annual addition to the lesser of 50 percent of the contribution and benefit base under the Social Security Act ($21,000 if the bill applied in 1986) or 20 percent of compensation.

The bill would provide that the annual addition under a nonretirement savings plan is the lesser of 25 percent of the contribution and benefit base under the Social Security Act ($10,500 if the bill applied in 1986) or 10 percent of compensation.

The bill would modify the definition of the annual addition by eliminating the exclusion for employee contributions of less than 6 percent of compensation. Accordingly, under the bill, one-half of all

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employee contributions would be taken into account in computing the annual addition.

***Cash-or-deferred arrangements***

Under the bill, an employee's elective deferral under a cash or deferred arrangement would be limited to the lesser of 25 percent of the contribution and benefit base under the Social Security Act ($10,500 if it applied in 1986) or 20 percent of compensation.

***Combined limits***

Although the bill would continue to apply separate dollar and percentage limits to defined benefit pension plans and defined contribution plans, the special limit on combined plans would be repealed if no plan in which an employee participates is top heavy.

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## E. Vesting Standards (secs. 121 and 221 of the bill, sec. 203 of ERISA, and sec. 411 of the Code)

### *Present Law*

#### *In general*

Prior to the enactment of ERISA, a qualified plan was required to provide vested (i.e., nonforfeitable) rights to employees when they attained the normal or stated retirement age. Qualified plans were also required to vest employees upon plan termination or the discontinuance of employer contributions. However, no preretirement vesting was required unless the absence of such vesting caused discrimination in favor of officers, shareholders, supervisors, or highly compensated employees.

To ensure that employees with substantial periods of service with the employer do not lose plan benefits upon separation from employment, ERISA and the Code generally require that (1) a participant's benefits be fully vested upon attainment of normal retirement age under the plan; (2) a participant be fully vested at all times in the benefit derived from employee contributions; and (3) employer-provided benefits vest at least as rapidly as under one of 3 alternative minimum vesting schedules (Code sec. 411(a)). Under these schedules, an employee's right to benefits derived from employer contributions becomes nonforfeitable (vested) to varying degrees upon completion of specified periods of service with an employer.

Under one of the schedules, full vesting is required upon completion of 10 years of service (no vesting is required before the end of the 10th year). Under a second schedule, vesting begins at 25 percent after completion of 5 years of service and increases gradually to 100 percent after completion of 15 years of service. The third schedule takes both age and service into account, but, in any event, requires 50-percent vesting after 10 years of service, and an additional 10-percent vesting for each additional year of service until 100-percent vesting is attained after 15 years of service.

#### *Patterns of discrimination*

Prior to ERISA, preretirement vesting was sometimes required under a qualified plan to prevent discrimination. Although ERISA required all plans to meet certain minimum preretirement vesting standards, ERISA also provided that earlier vesting may still be required under a qualified plan to prevent discrimination if (1) there has been a pattern of abuse under the plan tending to discriminate in favor of employees who are officers, shareholders, or highly compensated; or (2) there has been, or there is reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate



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in favor of employees who are officers, shareholders, or highly compensated (Code sec. 411(d)(1)).

***Top-heavy plans***

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) required earlier preretirement vesting for certain top-heavy plans to improve the likelihood that covered participants would receive benefits.[10] For any plan year for which a qualified plan is top heavy, an employee's right to accrued benefits must become nonforfeitable under one of 2 alternative schedules. Under the first top-heavy schedule, a participant who has completed at least 3 years of service with the employer maintaining the plan must have a nonforfeitable right to 100 percent of the accrued benefit derived from employer contributions.

A plan satisfies the second alternative (6-year, graded vesting) if a participant has a nonforfeitable right to at least 20 percent of the accrued benefit derived from employer contributions at the end of 2 years of service, 40 percent at the end of 3 years of service, 60 percent at the end of 4 years of service, 80 percent at the end of 5 years of services, and 100 percent at the end of 6 years of service with the employer.

***Class year plans***

Special vesting rules also apply to "class year plans." A class year plan is a profit-sharing or stock bonus plan that provides for the separate vesting of employee rights to employer contributions on a year-by-year basis. The minimum vesting requirements are satisfied if the plan provides that a participant's right to amounts attributable to employer contributions with respect to any plan year are nonforfeitable not later than the close of the fifth plan year following the plan year for which the contribution was made.

***Explanation of Provision***

The bill would amend ERISA and the Code to require that, in the case of a retirement plan, a participant who has completed at least 5 years of service have a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions. As an exception to this rule, the bill requires that in the case of a multiemployer plan that is a retirement plan a participant in the plan who has completed at least 10 years of service have a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions.

***Explanation of Provision***

The bill would amend ERISA and the Code to require that, in the case of a retirement plan, a participant who has completed at least 5 years of service have a nonforfeitable rigfht to 100 percent of the participant's accrued benefit derived from employer contributions. As an exception to this rule, the bill requires that in the case of a multiemployer plan that is a retirement plan.

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[10] A top-heavy plan is a qualified plan under which more than 60 percent of the benefits are provided for key employees (Code sec. 416).

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The bill would amend the Code and ERISA to require that in the case of a nonretirement savings plan, a participant who has completed at least one year of service has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions.

The provisions apply with respect to participants who have completed at least one hour of service on or after the date of enactment.

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## F. Pension Integration (secs. 131 and 231 of the bill, sec. 215 of ERISA, and sec. 401(1) of the Code)

### *Present Law*

#### *In general*

The Code provides nondiscrimination standards for qualified pension, profit-sharing, and stock bonus plans. These standards prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated. Under these standards, coverage tests are applied to determine whether the classification of employees who participate in a plan is discriminatory. Additional tests are applied to determine whether contributions or benefits under the plan discriminate in favor of highly compensated employees.

The rules prohibiting discrimination under qualified plans were adopted by the Congress in 1942. The nondiscrimination standard was adopted to "safeguard the public against the use of the pension plan as a tax-avoidance device by management groups seeking to compensate themselves without paying their appropriate taxes." [11] Congress was concerned that the requirement of nondiscriminatory coverage by a plan was not sufficient. Although nondiscriminatory coverage could assure that rank-and-file employees were not unfairly omitted from a plan, it could not assure that those employees would be provided with a fair share of benefits. Accordingly, the 1942 Act included standards requiring that a qualified plan provide nondiscriminatory benefits or contributions for plan participants. It was noted that even ". . . extended coverage would not by itself guarantee that the pension plan would be operated for the welfare of employees generally, because the scale of benefits could be manipulated. Therefore, the scale of benefits must be nondiscriminatory." [12] In determining whether benefits were discriminatory, the Congress noted that plans designed in good faith to supplement social security should be permitted to qualify for favorable tax treatment.[13] Thus, a plan that provides benefits which, when aggregated with employer-provided social security benefits, constitute a nondiscriminatory percentage of compensation is deemed to be nondiscriminatory even though plan benefits standing alone would not meet the nondiscrimination standard.

#### *Integration of defined benefit pension plans*

Generally, in applying the nondiscrimination test to benefits under a plan, the rate at which benefits are provided by the plan for highly compensated participants (as a percentage of their pay) is compared with the rate at which the plan provides benefits for

[11] H. Rpt. 77-2333, 77th Cong., 2d. Sess. 51 (1942).
[12] *Ibid.*
[13] See, e.g., S. Rpt. 1631, 77th Cong., 2d. Sess. 139 (1942).



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other participants. A similar test may be applied to employer contributions under a plan. A plan fails the nondiscrimination standard if both benefits and contributions discriminate in favor of highly compensated employees.

Under present law, in determining whether defined benefit pension plan benefits, as a percentage of nondeferred pay, discriminate in favor of employees who are highly compensated, the portion of each employee's social security benefits that are considered to be paid for by the employer may be taken into account. For this purpose, social security benefits mean old age, survivors, and disability insurance (OASDI) benefits provided under the social security system.

A plan that meets the nondiscrimination standards of the Code only if social security benefits are taken into account is referred to as an integrated plan. If these social security benefits and the employer-provided benefits under the plan, when added together, provide an aggregate benefit that is a higher percentage of pay for highly compensated employees than for other employees, then the benefits under the plan are discriminatory and the plan does not qualify. Either benefits or contributions under a plan may be integrated.

Two basic approaches to integration of defined benefit pension plans have been developed—(1) the "offset" approach, and (2) the "excess" approach.[14]

***Offset plans***

A defined benefit pension plan that integrates under the offset approach is referred to as an offset plan. An offset plan initially provides each employee with an annual pension benefit which (as a percentage of pay) does not discriminate in favor of highly compensated employees. For each employee, this initial benefit is then reduced, or offset, by the employer-provided portion of that employee's social security benefit to arrive at the actual pension benefit under the plan.

In 1971, the Internal Revenue Service determined that the value of employer-provided social security benefits is equal to 83⅓ percent of the annualized primary insurance amount (PIA) to which an employee is entitled under the Social Security Act. This calculation forms the basis of the present-law rules for integrating offset plans. Consequently, an offset plan could integrate its benefits with social security by providing each employee an annual benefit of, for example, 50 percent of pay offset by 83⅓ percent of the employee's PIA.

***Excess plans***

A pension plan that integrates under the excess approach is referred to as an excess plan. The basic theory underlying the excess approach is that social security provides benefits based on only a certain portion of an employee's earnings. An excess plan is designed to provide benefits (or added benefits) based on the portion of an employee's earnings "in excess" of the earnings on which

[14] Rules for integrating under these two approaches are set forth in Rev. Rul. 71-446, 1971-2 C.B. 187.

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social security benefits are provided (covered compensation). An excess plan integrates if the benefits it provides with respect to compensation in excess of covered compensation are not greater, as a percentage of pay, than the benefits provided by social security on covered compensation.

The Internal Revenue Service determined that the employer-provided portion of benefits under social security averages 37½ percent of the average maximum pay on which social security benefits are based. This calculation forms the basis of the present-law rules for integrating excess plans. Consequently, for an employee retiring at age 65 in 1986, an excess plan will integrate properly if it provides benefits at a rate no greater than 37½ percent of pay in excess of $15,000 (approximately the highest average annual wage upon which social security benefits can be based for such an employee), although it provides no benefits with respect to the first $15,000 of pay.

If an excess plan provides benefits on compensation up to covered compensation, then it can provide benefits at a higher rate on pay above the level of covered compensation. However, the rate at which benefits are provided above covered compensation cannot exceed the rate at which benefits are provided on compensation up to covered compensation by more than 37½ percent. For example, an integrated excess plan could provide benefits at the rate of 12½ percent for all compensation plus 50 percent (i.e., 37½ percent plus 12½ percent) of compensation in excess of covered compensation.

***Integration of defined contribution plans***

Defined contribution plans do not provide specified benefit formulas. Defined contribution plans provide for contributions to be allocated to and accumulated in a separate account for each employee. Accordingly, such plans are integrated by taking into account the employer-paid portion of social security taxes. Specifically, a defined contribution plan is integrated by reducing contributions to the plan with respect to the portion of an employee's pay subject to the social security tax (i.e., the taxable wage base).

Prior to 1984, the integration of a defined contribution plan was based on the IRS-calculated cost of employer-provided social security benefits. For pre-1984 years, the Internal Revenue Service had determined that the employer's cost of providing social security benefits was seven percent of pay subject to the tax.

Effective for plan years beginning after 1983, TEFRA revised the integration rules for profit-sharing and other defined contribution plans. TEFRA permits an employer to reduce plan contributions on behalf of an employee by no more than an amount equal to the employee's taxable wage base multiplied by the actual OASDI tax rate. Thus, a profit-sharing plan could provide contributions of 5.7 percent (the OASDI tax rate) of 1986 pay in excess of $42,000 (the 1986 taxable wage base) and no contributions for 1986 with respect to the first $42,000 of pay. Similarly, if a plan provided for 1986 contributions of 10 percent of pay in excess of $42,000, it would integrate properly only if it provided for 1986 contributions of at least 4.3 percent with respect to the first $42,000 of pay.

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***Top-heavy plans***

A qualified plan that is top heavy must provide a minimum nonintegrated benefit or contribution derived from employer contributions for each employee who is a participant in the plan and who is not a key employee (sec. 416). The rule is designed to reflect the higher proportion of tax benefits focused on key employees in a top-heavy plan.[15]

A defined benefit pension plan satisfies this minimum benefit requirement if, on a cumulative basis, the accrued benefit of each participant who is not a key employee, when expressed as an annual retirement benefit, is not less than two percent of the employee's average annual compensation from the employer, multiplied by the employee's years of service with the employer. However, an employee's minimum benefit is not required to exceed 20 percent of such average annual compensation. This required minimum benefit may not be eliminated or reduced on account of the employee's social security benefits attributable to contributions by the employer (i.e., the minimum benefit is a "nonintegrated" benefit).

For a plan year for which a defined contribution plan is a top-heavy plan, the employer generally must contribute on behalf of each plan participant who is not a key employee an amount not less than three percent of the participant's compensation. The minimum contribution must be made for each year in which the plan is top heavy. However, special rules provide that if the employer's contribution rate for each participant who is a key employee for the plan year is less than three percent, then the required minimum contribution rate for each non-key employee generally is limited to the highest contribution rate for any key employee.

Amounts paid by the employer for the year to provide social security benefits for the employee are disregarded. Thus, the required minimum contribution for a non-key employee may not be eliminated or reduced on account of benefits attributable to social security taxes paid by the employer (i.e., the minimum contribution is a "nonintegrated" contribution).

***Explanation of Provisions***

***In general***

The bill would revise the integration rules under the Code for qualified plans and would add to labor law the prohibition applicable to qualified plans under present law against discrimination by a plan in favor of specified employees. Under the bill, a pension plan would not be considered to violate the nondiscrimination rules of the tax law or the labor law merely because the plan is integrated.

***Certain discrimination prohibited by ERISA***

The bill would extend to all plans subject to ERISA the present law nondiscrimination rule applicable to qualified plans. Under

[15] Generally, a plan is top heavy if more than 60 percent of the benefits it provides are for key employees (sec. 416).

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this rule, the contributions and benefits provided under a pension plan may not discriminate in favor of employees who are officers, shareholders, or highly compensated. Employees in certain collective bargaining units and certain nonresident aliens may be excluded from consideration in testing whether a plan meets the requirements of the prohibition against discrimination.

***Nondiscriminatory integration***

The bill would provide that a plan would not violate the nondiscrimination rules of labor law or of the Code merely because it is an integrated plan. The bill defines an integrated plan as a plan that is discriminatory solely because it provides a contribution or benefit that meets specified requirements. The bill provides requirements for formulas under excess plans and under offset plans.

***Excess plan requirements***

Under the bill, the integration ratio of a plan is not to exceed the permitted level. In the case of a defined contribution plan, the integration ratio is a fraction (1) the numerator of which is the rate of employer contributions based on compensation up to the integration level, and (2) the denominator of which is the rate of employer contributions based on compensation in excess of that level. Under the bill, the minimum integration ratio of a plan is 50 percent. The bill defines the integration level of a plan as an amount that does not exceed the contribution or benefit base under the Social Security Act as of the beginning of the plan year ($42,000 for plan years beginning in 1986). The bill provides corresponding rules for benefits under defined benefit pension plans.

For example, a defined contribution plan would be considered to be integrated properly under the bill if the rate of contributions to the plan based on compensation at or below the wage base is at least 50 percent of the rate of contributions based on compensation in excess of the wage base. If a plan provided contributions to the plan at the rate of 10 percent for compensation in excess of $42,000 (the wage base for 1986), then the plan would be considered nondiscriminatory if the rate of contributions to the plan is at least 5 percent for compensation at or below $42,000.

The bill would authorize the Secretary of the Treasury to prescribe regulations requiring an increase in the minimum integration ratio under a defined benefit pension plan (or a class of defined benefit pension plans) to the extent necessary to eliminate any additional discrimination otherwise forbidden by the bill attributable solely to the value of the plan features (constituting the form of benefit, any preretirement benefits, the vesting schedule, the normal retirement age, and any actuarial adjustment factors) with respect to benefits attributable to compensation in excess of the specified integration level, taking into account the value of such features with respect to benefits attributable to compensation not in excess of the specified integration level.

The bill would also authorize the Secretary of the Treasury to prescribe regulations requiring increases in the minimum integration ratio under a defined benefit pension plan (or a class of defined benefit pension plans) that provides for mandatory employee contributions (sec. 411(c)(2)(C) of the Code and sec. 212(e)(4) of

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ERISA) to the extent necessary to eliminate any additional discrimination otherwise prohibited by the bill attributable solely to the ratio which employee contribution rates applicable to compensation which is not in excess of the integration level bears to employee contribution rates applicable to compensation which is in excess of that level.

***Offset plan requirements***

Under the bill, the contribution or benefit formula of a plan meets the offset plan requirements if, under that formula, to the extent consistent with requirements of the bill relating to minimum benefits, the normal retirement benefit with respect to each participant is expressed in the form of a benefit which is a specified percentage of compensation, reduced by the permitted offset. Under the bill, the permitted offset is a percentage specified by the plan (not more than 100 percent) of the primary insurance amount (sec. 215 of the Social Security Act) of the participant (or any other individual on whose wages and self-employment income the participant's entitlement to monthly social security benefits is based), determined as of the earlier of the date of the commencement of the participant's entitlement to benefits under the Social Security Act or the date of the participant's separation from service.

Under the bill, the benefit requirement for an offset plan is met if the accrued benefit derived from employer contributions (sec. 411(a)(7) of the Code and sec. 204(c)(1) of ERISA) provided to each participant is not less than 50 percent of the accrued benefit that would be derived from employer contributions if the plan did not take social security benefits into account.

The bill limits the authority of the Secretary to prescribe regulations relating to the criteria for determining whether the requirements relating to the offset formula are satisfied. Under the bill, in any regulations prescribed by the Secretary for purposes of determining whether the offset plan requirements have been met, the form of benefit, preretirement benefits, or similar plan provisions are not to be taken into account.

***Treatment of multiple plans***

The bill would provide that, for purposes of the integration rules, if an employee is eligible to participate in 2 or more retirement plans that are maintained by the same employer, the plans are to be treated as a single plan with respect to the employee.

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## G. Distributions (Secs. 241 and 242 of the bill and secs. 402, 403, and 408 of the Code)

### *Present Law*

***Lump-sum distributions***

Under present law, a lump-sum distribution from a qualified plan may qualify for special 10-year forward income averaging. In addition, the portion of a lump sum attributable to contributions prior to January 1, 1974, may qualify for capital gains treatment.

***Additional income tax on early withdrawals***

Generally, under present law, a 10-percent additional income tax is imposed on withdrawals from an IRA before the owner of the IRA attains age 59½, dies, or becomes disabled.

### *Explanation of Provisions*

***Lump-sum distributions***

The bill would repeal the 10-year averaging and capital gains treatment for lump-sum distributions from qualified plans.

***Additional income tax on early withdrawals***

Under the bill, the 10-percent additional income tax on withdrawals from an IRA by the owner prior to attainment of age 59½, death, or disability would be increased to 20 percent.



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## H. Coverage and Portability

### 1. Early distributions of benefits (secs. 141 and 251 of the bill, secs. 203 and 205 of ERISA, and secs. 411 and 417 of the Code)

#### *Present Law*

Under present law, in the case of an employee whose plan participation terminates, a pension plan may involuntarily "cash out" the benefit (i.e., pay out the balance to the credit of a plan participant without the participant's consent) if the present value of the benefit does not exceed $3,500. If a benefit is cashed-out under this rule, and the participant subsequently returns to employment and is covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which benefits were cashed out unless the employee "buys back" the benefit.

In addition, present law provides that, if the present value of an accrued benefit exceeds $3,500, then the benefit may not be immediately distributed without the consent of the participant (and, if applicable, the participant's spouse).

Present law provides that the present value of a qualified joint and survivor annuity may be immediately distributed if the value does not exceed $3,500. In addition, if the present value of a qualified joint and survivor annuity or a qualified preretirement survivor annuity exceeds $3,500, the plan may immediately distribute all or part of the present value of the annuity only if the participant and the participant's spouse (or the surviving spouse, if the participant has died) consents in writing to the distribution.

Under present law, the interest rate to be used in determining whether the present value of a benefit exceeds $3,500 may not be greater than the interest rate that would be used (as of the date of the distribution) by the Pension Benefit Guaranty Corporation (PBGC) for purposes of determining the present value of a lump sum distribution upon termination of the plan. The PBGC rate in effect at the beginning of a plan year may be used with respect to distributions made at any time during the plan year if the plan so provides.

Generally, a cash-out distribution from a qualified plan (whether voluntary or involuntary) may be rolled over, tax free, to an IRA or to another qualified plan if certain requirements are met.

#### *Explanation of Provision*

Under the bill, an accrued benefit would not be treated as nonforefeitable unless, in the case of any lump-sum distribution made before a participant attains age 59½, dies, or becomes disabled, the distribution is made in a direct transfer (after notice to the participant or the participant's beneficiary) to an individual retirement



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account or annuity (an IRA). The participant or the participant's beneficiary (if the participant has died) would be required to designate the IRA and to demonstrate to the satisfaction of the plan administrator that the account or annuity is willing to accept the transfer.

The bill provides that, if the participant or the participant's beneficiary fails to designate an IRA for receipt of an involuntary cash out within 60 days after the notice from the plan administrator, the plan administrator would be permitted to make a direct transfer to an IRA selected by the plan administrator.

In addition, the bill provides that similar rules would apply to the cash-out of benefits with respect to a qualified joint and survivor annuity and a qualified preretirement survivor annuity.

**2. Special rules for simplified employee pensions (secs. 252–254 of the bill and sec. 408(k) of the Code)**

***Present Law***

***In general***

Under present law, if an IRA qualifies as a simplified employee pension (SEP), the annual IRA deduction limit is increased to the lesser of $30,000 or 15 percent of compensation. The increased deduction limit applies only to employer contributions.

An IRA qualifies as a SEP for a calendar year if certain requirements relating to employee withdrawals and the employer contribution allocation formula are met. The allocation rules are designed to insure that employer contributions are made on a basis that does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

***Integration of SEP benefits with social security***

Under present law, a SEP is not qualified unless the employer contributions are nondiscriminatory without taking into account the employer's contributions on behalf of employees to social security. However, if the employer does not maintain any other integrated plan, then the employer's contributions (OASDI contributions) on behalf of an employee to social security may be taken into account as contributions by the employer to the SEP, but only if such contributions are taken into account with respect to each employee maintaining a SEP.

Present law provides that an integrated plan is a plan that would not meet the qualification requirements if social security contributions were not taken into account.

***Explanation of Provisions***

***In general***

The bill would revise the qualification requirements relating to SEPs to permit employees to elect to have SEP contributions made on their behalf or to receive the contribution in cash. In addition, the bill would repeal the provision permitting SEP contributions to be integrated with social security and would apply a limitation on

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annual SEP contributions that is tied to the contribution and benefit base under the Social Security Act.

***Salary reduction SEPs***

Under the bill, employees who participate in a SEP would be permitted to elect to have contributions made to the SEP or to receive the contributions in cash. The election to have amounts contributed to a SEP or to receive the amounts in cash would be available only in a taxable year in which the employer maintaining the SEP has 25 or fewer employees as of the beginning of the taxable year. If an employee elects to have contributions made on the employee's behalf to the SEP, the contribution would not be treated as having been distributed or made available to the employee. In addition, the contribution would not be treated as an employee contribution merely because the SEP provides the employee with such an election. Therefore, under the bill, an employee would not be required to include in income currently the amounts an employee elects to have contributed to the SEP.

The bill provides that the election to have amounts contributed to a SEP or received in cash would be available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP. In addition, under the bill, the amount eligible to be deferred as a percentage of an owner-employee's compensation (i.e., the deferral percentage) would be limited by the average deferral percentage for all other employees who participate. The deferral percentage for each owner-employee cannot exceed the deferral percentage for all other participating employees by more than 150 percent.

For purposes of determining the deferral percentages, an employee's compensation would be the amount of the employee's compensation taken into account under the SEP for purposes of calculating the contribution that may be made on the employee's behalf for the year. Further, if an employee participates in more than one SEP of the employer, the employee's deferral percentage is the sum of the employee's deferral percentages under each of the SEPs.

In addition, the provision permitting employees to elect to defer compensation under a SEP would not apply unless the trustee of the SEP assumed the fiduciary duties imposed under ERISA.

***Integration under SEPs***

Under the bill, for purposes of testing whether the contributions or benefits under a SEP are nondiscriminatory, the contributions made by the employer on behalf of employees to Social Security could not be taken into account.

***Wage-based contribution limitation for SEPs***

Under the bill, the limit on compensation taken into account under SEPs would be revised to equal 500 percent of the contribution and benefit base in effect for the year under the Social Security Act, $210,000 in 1986.

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## I. Effective Dates

The bill generally would be effective with respect to any plan for plan years ending after the later of 2 years after the date of enactment of the bill or the earlier of (1) the effective date of the first plan amendment adopted after the date of enactment or (2) December 31, 1990. The provisions relating to individual retirement arrangements would be effective for taxable years ending after December 31, 1990.

A special effective date would be provided for collectively bargained plans. In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before the date of enactment, the bill would be effective for plan years ending after the later of 2 years after the date of enactment or the earliest of (1) the date on which the last of the collective bargaining agreements relating to the plan terminated (determined without regard to any extension ratified after the date of enactment), (2) the effective date of the first plan amendment adopted after the date of enactment, or (3) December 31, 1990.

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